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ASSET MANAGEMENT (C.I.) LIMITED

Investment Memorandum

The ability of the financial system to shock seems gradually to be lessening but the economic news and immediate prospects remain dire. This is reflected in equity market movements in the last quarter although, for sterling investors, considerable relief was provided by the weakness of sterling leaving returns little changed over the quarter. Top quality bonds showed a good return but trends reversed sharply towards the end of the quarter.

The tables below detail relevant movements in markets :

International Equities 31.10.08 - 31.01.09

Total Return Performances (%)

Country	Local Currency	£	US$	€
Australia	-11.8	-4.8	-15.0	-15.9
Finland	-20.2	-9.6	-19.3	-20.2
France	-1.6	-12.2	-13.2	-15.4
Germany	-15.4	-4.1	-14.5	-15.4
Hong Kong, China	-3.1	+15.5	+3.0	+2.0
Italy	-14.5	-3.2	-13.6	-14.5
Japan	-9.5	+11.1	-0.9	-1.9
Netherlands	-5.8	+6.7	-4.8	-5.8
Spain	-5.6	+6.9	-4.6	-5.6
Switzerland	-13.6	-2.5	-13.0	-13.9
UK	-4.3	-4.3	-14.6	-15.5
USA	-13.9	-3.5	-13.9	-14.8
Europe ex UK	-12.2	-1.2	-11.8	-12.7
Asia Pacific ex Japan	-5.1	+3.1	-8.0	-9.0
Asia Pacific	-7.8	+7.6	-4.0	-5.0
Latin America	+4.4	+7.8	-3.8	-4.8
All World All Emerging	-3.1	+4.4	-6.9	-7.9
The World	-11.1	-0.9	-11.5	-12.5

Source FTSE World Indices

FT Government Securities Index All Stocks (total return) : +4.9%

International Bonds – Benchmark Ten Year Government Bond Yields (%)

Currency	31.10.08	30.01.09
Sterling	4.53	3.71
US Dollar	3.96	2.84
Yen	1.49	1.29
Germany (Euro)	3.91	3.31

Sterling's performance during the quarter ending 30.01.09 (%)

Currency	Quarter Ending 30.01.09
US Dollar	-10.8
Canadian Dollar	-9.0
Yen	-18.5
Euro	-11.7
Swiss Franc	-11.3

Other currency movements during the quarter ending 31.01.09 (%)

Other Currency	Quarter Ending 31.01.09
US Dollar/Canadian Dollar	+2.0
US Dollar/Yen	-8.7
US Dollar/Euro	-1.1
Swiss Franc/Euro	-0.4
Euro/Yen	-7.7

Significant Commodities (US dollar terms) 31.10.08 - 30.01.09 (%)

Significant Commodities	31.10.08 - 30.01.09
Oil	-29.8
Gold	+26.6

Markets

Against the background of the international financial crisis and the move into economic recession, equity markets showed marked weakness during the quarter although sterling based investors were shielded from the worst of the decline because of the currency's marked weakness during the quarter. In total return local currency terms, the FTSE World Index returned -11.1%, -0.9% in sterling terms, -11.5% in US dollar terms and -12.5% in euro terms. Within the local currency returns, the only area to show a positive performance was Latin America (+4.4%). The UK held up relatively well (-4.3%) but the USA (-13.9%), Europe ex UK (-12.2%) and Japan (-9.5%) all showed marked weakness. However, it was quite a different story in sterling terms where the UK underperformed all of those areas. The FTSE Japan Index returned 11.1% in sterling terms, Asia Pacific ex Japan 3.1%, Latin America 7.8% and emerging markets 4.4%. Elsewhere, the performance of the FTSE USA Index (-3.5%) and the FTSE Europe ex UK Index (-1.2%), whilst negative, outperformed the FTSE UK Index (-4.3%).

High quality government bonds enjoyed a good quarter. Taking ten year government bonds as a benchmark, the gross redemption yields on sterling bonds fell by 82 basis points to 3.7%, on US dollar bonds by 112 basis points to 2.84%, on yen bonds by 20 basis points to 1.29% and on German government euro denominated bonds by 60 basis points to 3.31%. These performances mask weakness at the end of the quarter.

Although showing some recovery towards the end of the quarter, sterling endured a dismal quarter. Against the yen, it fell by 18.5%, against the euro by 11.7%, against the Swiss franc by 11.3%, against the US dollar by 10.8% and against the Canadian dollar by 9.0%.

In the commodity markets, oil fell by 29.8% but gold rose by 26.6%, perhaps reflecting fears of inflation down the line as a result of economic policies being followed to kick start the world economy.

Economics

In recent reviews, rather than use part of the discussion to evaluate the latest economic data, we have tried to make sense of what is happening from an investment perspective and to look forward. In such a fast moving situation, data soon becomes redundant and it does not have the usual value from an investment perspective. We would like to return to that format in our reviews when some semblance of normality returns.

One exception we will make is the IMF's latest World Economic Outlook published on 28 January. Whilst economic forecasts are being revised very rapidly, nearly always for the worse, they do show how bad the immediate economic outlook is.

We show below extracts from the World Economic Outlook.

Abridged Summary of Projections from the IMF's World Economic Outlook January 2009

World Output (%)

	2007	2008	2009 (est)	2010 (est)	Difference from November 2008 Projections 2009	Difference from November 2008 Projections 2010
Advanced economies	5.2	3.4	0.5	3.0	-1.7	-0.8
USA	2.0	1.1	-1.6	1.6	-0.9	0.1
Eurozone	2.6	1.0	-2.0	0.2	-1.5	-0.7
Germany	2.5	1.3	-2.5	0.1	-1.7	-0.4
France	2.2	0.8	-1.9	0.7	-1.4	-0.8
Italy	1.5	-0.6	-2.1	-0.1	-1.5	-0.1
Spain	3.7	1.2	-1.7	-0.1	-1.0	-0.9
Japan	2.4	-0.3	-2.6	0.6	-2.4	-0.5
UK	3.0	0.7	-2.8	0.2	-1.5	-0.9
Newly industrialised Asian economies	5.6	2.1	-3.9	3.1	-6.0	-1.1
China	13.0	9.0	6.7	8.0	-1.8	-1.5
India	9.0	7.3	5.1	6.5	-1.2	-0.3

Consumer Prices (%)

	2007	2008	2009 (est)	2010 (est)	Difference from November 2008 Projections 2009	Difference from November 2008 Projections 2010
Advanced economies	2.1	3.5	0.3	0.8	-1.1	-0.8
Emerging and developing economies	9.6	5.6	-0.8	5.4	-5.8	-3.5

Source IMF World Economic Outlook January 2009

Whether or not these projections turn out to be broadly accurate, not many people will dispute the trend. As shown by the difference from the November 2008 projections, the deterioration in the world economy has been alarming. The IMF now forecasts very little growth in world output, just 0.5% this year, although it forecasts quite a rebound next year to 3.0%, still well below 2007's level of 5.2%. The magnitude of the downgrade for this year, 1.7%, from November's projection is enormous. There is obviously no hiding place from this recession but, in absolute terms, the IMF thinks the outlook for this year is particularly grim for the UK, Japan and Germany as well as the newly industrialised Asian economies. Although China and India are expected to show growth of which the larger industrialised economies can only dream, their projected growth rates are only a shadow of those of 2007, although, as in most other countries, the IMF is expecting some recovery next year, albeit to very low levels. Whilst some economists fret about the possibility of deflation, the IMF sees a low level of inflation in 2009 and 2010. The only construction that one can put on any of these forecasts is that the situation is very grim.

So where are we now? At some stage, "green shoots" for which politicians are desperately looking will appear and there will be a recovery. The stock market will probably anticipate this. There is no doubt that there will be a bit of economic and social pain before the recovery, with unemployment rising sharply and more companies going out of business. We are already seeing signs of social unrest in a number of countries and, unfortunately but inevitably, protectionist sentiments are growing. Well before the financial system imploded, we had warned in these reviews about the dangers of protectionism although we had obviously not anticipated that they would arise in a situation such as the world economy now sees itself.

Before we go on to discuss protectionism, we should discuss what, if anything, has got better since the financial crisis started. So far, to us, it seems as if the most worrying phase was last October when there was a serious fear on the part of depositors that their cash at the banks was not safe. Whilst investors expect their securities to fluctuate in value, never, in their wildest dreams, would they expect to fear for the safety of their deposits. We believe that actions by governments and central banks to safeguard depositors have been effective and that the peak point of concerns on this score has now passed. Whilst everyone knows how bad times are at present, a run on the banks, which threatened at one stage to develop, appears to have been averted. A second point of concern also seems to have improved. Whilst banks hoarded cash partly because they were fearful of lending it to other banks, inter bank lending rates remained extremely elevated and, therefore, the transmission effects arising from the dramatic fall in official interest rates were minimal. Now the inter bank markets, as measured against official interest rates, are much less stressed. Actions taken by governments and central banks to restore confidence have been effective. Where the stress now lies is in the cautious attitude by banks towards lending to businesses. Here there is a big problem. After their experience of write downs and write offs, the banks need to restore their profitability and rebuild their capital base in part to pay off governments which have invested in them. On the other hand, governments are pressing them to lend on terms which banks may not consider prudent. It is of no value to point out that some banks were authors of their own misfortune because we are where we are and need to look forward. Banks have to restore their profitability and have a strong capital base. We cannot be sure how this contradiction in aims will work itself out. One consequence which is evident in the figures is that British banks, at least, are concentrating their lending on the home market rather than to foreign borrowers so we are seeing a kind of protectionism in this market and it is probably happening elsewhere as well.

The UK government, in particular, is also keen that banks raise their current very low lending levels to prospective house purchasers in order to revive the housing market. This is a difficult one because house prices, notwithstanding their sharp fall in the last year, are still considered to be overvalued by historical standards and it was overextended borrowers in the USA and UK who contributed to the current problems in the financial system. Banks have learnt their lesson and 125% mortgages are a thing of the past now. From an economic perspective, falling house prices exert a negative wealth effect on the economy as consumers lack confidence to spend which has a reverse multiplier effect on economic activity. The government, in the current exceptional circumstances, would probably prefer to risk the dangers of a still overvalued housing market in the interests of trying to stimulate some economic activity through the housing market.

Another way in which "green shoots" may be encouraged to grow will be through an improvement in disposable incomes amongst those in work. As the IMF's table shows, we are in a disinflationary environment, i.e. one where the rate of increase in prices slows down and it is possible that some countries will enter a deflationary environment, i.e. one where price levels actually fall. The latter situation is problematical but both situations can produce an increase in disposable incomes. To take a current example, the price of petrol has fallen significantly from its peak. Other things being equal, motorists have more money in their pockets. Some people may feel confident enough to spend their additional disposable income. Those businesses and individuals who have floating rate loans may experience a boost to disposable incomes through lower servicing charges. Against this, we should note that those who rely on interest income to support their life style are having a very difficult time with interest rates having fallen to such low levels. In the UK, it is estimated that there are seven times as many savers as borrowers.

Another "green shoot" will be more M & A activity. Many companies look very cheap but companies having the confidence to buy them or make a takeover approach is another matter. But once one moves, others may follow and an increase in M & A activity will restore some confidence to equity markets. As it happens, even though it is generally regarded as taking place for defensive reasons, we have just seen a very large bid in the pharmaceutical sector with Pfizer making an offer for Wyeth in a mixture of securities and cash. If we do see a recovery in the stock market, that, too, is likely to engender more confidence. One reason why shares may start to recover is the very poor returns being earned on cash and the inadequate yields on top quality bonds. Even though 2009 is bound to be a very poor year for corporate earnings, many companies will maintain their dividends and some will increase them. If investors feel slightly less worried about the international financial situation, they might be attracted to equities for their yields since short term interest rates are likely to remain low for the foreseeable future.

Then, of course, there is the macro economic position. It goes without saying that it is grim. The evidence is all around us. But we also note that the IMF is forecasting that world output next year, after growing by just 0.5% this year, will grow by 3.0% in 2010. Whether that proves to be the case or not, the IMF will have a reason for this expectation, and that is provided by the fiscal and monetary stimulus being provided almost everywhere. The sheer magnitude of the various stimuli must surely have some effect even though it will leave a mighty hangover in the years to come with their legacy of debt.

At a time when the economic news is so grim, it is important to focus on likely positive features for the equity markets. Although sentiment in markets is poor at the moment, it has been worse. Movements from day to day are unpredictable. One of the reasons for this is the continual deleveraging which is going on in the hedge fund industry as well as its need to raise funds to meet redemption requests. Besides the commercial and investment banks, one of the great casualties of the financial crisis has been the hedge fund industry. From now onwards, it will be a much smaller industry and will have to face much more rigorous regulation. The famously large fees earned will become more modest and many funds will not find it worthwhile to continue. Excessive leverage which has given some funds big problems will be reduced as a result of necessity (the strategy is too risky and the banks will not lend). Gearing up to improve returns has proved to be a risky strategy.

The position for the industry has been exacerbated by the Madoff scandal. The size of the alleged fraud, US$50 billion is often mentioned, is staggering and the circle of victims is very wide. It is obviously highly damaging for the hedge fund industry and its immediate effect is likely to be a further round of redemptions. All this will contribute to short term market volatility as marketable securities are sold. Eventually, but we do not know when, this forced selling will work itself out.

What will be the consequences of borrowing on this vast scale? We think that it will have a very negative effect on the bond markets. The enormous supply of new government bonds will almost certainly push up yields as buyers require more realistic interest rates on the amount they are being asked to buy. The inflationary consequences of the fiscal and monetary stimuli are likely to be felt later although with the current disinflationary environment this may be hard to imagine. But quantitative easing, the modern equivalent of printing money, is likely to result in increased inflation and the level of yields shown in our table at the beginning are likely to prove woefully inadequate. In fact, although the yields show a dramatic drop over the quarter, implying a good total return, the picture since the turn of the year has been quite different. Taking the ten year government bond as a benchmark over the quarter, UK gilts have shown a rise in a gross redemption yield of 61 basis points, US government bonds 74 basis points, Japanese government bonds 10 basis points and German government bonds 40 basis points. The absurdly low yields seen towards the end of last year reflected fears about the banking system and we are now seeing moves towards realistic pricing of top quality bonds although we feel there is a long way to go. If one believes that the current gross redemption yield of 4.34% on the 2055 UK gilt is a realistic one has to believe in a very low level of long term inflation and a continued top credit rating for the UK. Particularly with regard to the long term inflation outlook, we believe that the assumption is taking a lot on trust. For the foreseeable future, markets will have to absorb vast amounts of issuance of government debt which may also be expected to weigh on yields.

One concern which may well come to a head this year is the consequence of widely diverging yields in the eurozone bond market. It was always probable that the eurozone could come under pressure at some stage because of the strains inherent in a monetary union which did not represent an optimal currency zone. The financial crisis has brought matters to a head earlier than anticipated and it is difficult to see how the issue will go away. The disciplines surrounding entering into the euro and the Stability and Growth Pact were meant to ensure a convergence of economic performance so that strains would not occur. That was always wishful thinking because the economies comprising the eurozone have such different characteristics which are being demonstrated more than ever now. As a result of recent credit rating downgrades, the spread in credit ratings is widening, exactly the opposite of what was supposed to happen. The spread between the most highly rated credit, Germany and the most lowly rated credit, Greece, as measured by ten year government bonds is over 250 basis points, an enormous difference compared with the current gross redemption yield of around 3.31% on Germany's ten year bond. Even the second most highly regarded credit, France, is suffering the indignity of over a 50 basis point spread against Germany.

The problem is that the recession is finding out the weakest economies and, at a time when the unbelievable has happened, investors do not find it strange to be concerned about the creditworthiness of certain eurozone governments. The more countries like Greece have to pay on their debt, the worse their budgetary position becomes and there exists no mechanism for the eurozone bailing out its members.

The major disadvantages of a currency union like the eurozone are that its members lose control of their interest rates and their exchange rate (in the sense that the members share the same currency). Only fiscal policy is in their hands and, even there, in normal circumstances, the constraints of the Stability and Growth Pact would apply. If one looks at some of the members currently experiencing particular problems within the eurozone, say Spain or Greece, they have steadily been losing competitiveness against some other eurozone members. As a result, growth prospects are threatened, current account and budget deficits widen and unemployment rises. As we have seen, this can lead to social unrest. In the past, countries in this position had the option of devaluation. In the short term, this could provide some relief although at a long term cost. Without this option, what could happen? Those who believe that leaving monetary union is impossible point to the heavier debt burden that would immediately occur as the de facto devaluation raised the burden of euro denominated debt. A default would be more likely in those circumstances. There would be a feeling that some eurozone driven bail out might occur even though there is no formal mechanism for such. But there would be enormous resistance to such a move in Germany, for example, so political hurdles could block this. The alternative looks very unpalatable for these counties. If competitiveness has been eroded and devaluation is not an option in the absence of an independent currency, then a fall in real wages relative to other countries would be necessary. If it were a minor fall, it might be possible but, if it were a major fall, it would be difficult to see how this would occur without very severe social unrest which would undermine the fabric of society. Whatever happens, the problem is not going to go away, much as the politicians might want it to do. Just as the foreign exchange markets last year delivered an indictment of the UK's economic performance, so investors within a currency zone can do so for individual countries via interest rate differentials against stronger countries. Whichever way the problems of weaker members of the eurozone are resolved, it is going to be painful and it could also affect the performance of the euro. This, we feel, with be an issue for 2009.

Also within the eurozone and the wider European Union, but also elsewhere, protectionist sentiment is gathering pace. It takes different forms. Assistance to the banking sector was provided in great haste in the EU, raising state aid questions. In the USA, the election of a Democratic President and Congress has raised protectionist moves, Democrats usually being more inclined to protectionism. We do not know the outcome but the proposed stimulus to the US economy has attached to it a condition that US steel is used in infrastructure projects. Only a few years ago, President Bush imposed a tariff on steel imports. When times get tough, as at present, politicians are tempted to take populist actions. At the time of writing, the UK is facing various industrial disputes over the use of foreign EU labour by contractors at a Lincolnshire refinery, all of which appears to be permitted under EU law. When things are going well, these issues do not surface or do not become so visible. Now, with unemployment rising rapidly, they become an understandable focus of discontent. The downside of free trade and globalisation is all too visible; the much stronger benefits are harder to discern. For investors, it is worth spelling out what these are because it is a long term stock market issue. Protectionism raises the cost of goods and services and leaves most people worse off. Whether it be tariffs or quotas on imported goods or the insistence that a more expensive domestic option is taken, costs are raised and there is less disposable income to spend on other goods and services. So growth is reduced, which worsens employment prospects which depresses economies which, in turn, depresses company profits against what they would otherwise be. Generally speaking, goods and services are best made or provided in countries which have a comparative advantage in a particular area. Protectionism, if it takes hold, has the potential to slow economic recovery and, further out, to do long term economic damage. With the immediate turmoil, this may not be at the forefront of investors' minds but it is an important issue to monitor because, if protectionism gains hold, long term growth prospects will diminish.

Another worry for economists is that the world will enter a period of deflation rather than disinflation, the current position. This would occur if, as in Japan in the past, the monthly fall in the price levels becomes chronic rather than sporadic. The critical economic factor would be when falling price levels affect business and consumer behaviour. The odd monthly fall in prices is unlikely to do that but a longer period will.

We have become so used to inflation becoming a problem in the past that the dangers of deflation have never had to be considered in the West in most people's lifetimes. Should we enter a period of deflation, we can expect some very unpleasant side effects. Businesses would face a buyer's strike as other businesses and consumers hold off discretionary purchases in the expectation of paying a lower price later on. Revenue would be affected not only by lower volumes but by falling prices on lower volumes as well whilst it would be difficult to reduce pay costs proportionately. This would be a serious financial issue for many businesses and lead to many business failures. Furthermore, whilst individuals and businesses have been used to inflation eating away at the real cost of their liabilities, the opposite applies in a deflationary environment. For individuals, the classic example is a home mortgage. For years, not only has the real value of the liability been eroded by inflation but house prices have risen, creating the unhealthy bubble we have seen in house prices in recent years. The opposite situation of falling house prices and rising real liabilities would be truly toxic for the economy. In some countries, the UK, USA, Spain and Ireland come to mind, the first part of the problem is highly visible. We must hope the second part does not occur.

What is probable is that certain countries will experience some type of deflationary experience but that it will not be widespread. It is likely that the enormous stimulus applied to the world economy will have some effect on demand and inflation. In countries, like the UK, where there has been a substantial devaluation there will be inflation developing in the system even if the effects are diluted by weak demand arising from the international economic situation. The sharp fall in the oil price has brought down inflation levels having helped to take them up. But OPEC is now having some success in holding the line at these much lower price levels as it institutes significant production cuts and, in normal economic circumstances, the supply position is tight. So many unimaginable things have happened in the world economy and financial system in 2008 that one is cautious about making any forecasts but the sheer size of the stimulus given to the world economy and the prospect of quantitative easing makes the return of inflation a probability in the next year or two. If that is a correct assessment, deflation and its unpleasant side effects is at least one problem which can be put aside. Inflation figures over the coming months will be watched with particular interest.

Economic forecasts are fraught with danger at the present time, given the unexpected news which we have had over the past year or so. However, with that caveat, we would say that the likelihood of a run on major banks is unlikely. Governments and central banks appear to have dealt with that issue and depositor confidence has returned. It has turned out that large commercial banks are too big to fail in the sense that official support is forthcoming in one way or another. Residual concerns remain that some banks' balance sheets are very big in relation to their home country's GDP (Iceland is an example here). Investment banks have not had the same protection offered to them and allowing Lehman Brothers to go is probably now recognised as a mistake. The consequences have been dreadful. Through governments' investments in banks, guarantees, central banks' actions to free up liquidity through actions such as buying in a much wider range of assets than would normally be considered, some semblance of normality has been restored. This can be seen in much less elevated spreads in the inter bank market. A resumption of lending to normal risks and the reopening of the corporate bond markets to good quality credits will be helpful. Earlier, we talked about what the early "green shoots" might be. We should see some of these signs this year when the news goes from being totally bad to slightly less so and a more positive trend develops.

Notwithstanding the current dire economic and financial news background, out of equities, cash and high quality bonds, we would rate equities as likely to provide the best return this year on the evidence currently available to us. The dangers of making predictions are shown by events last year which unfolded in an unimaginable way. It is difficult to believe that there could be such surprises this year. Everyone knows how bad the situation is. Overall, equities offer good yields against cash and bonds, even after the recent pick up in the latter. High yields and low ratings would seem to discount some very poor corporate earnings figures to be announced. Forced selling of shares, for reasons mentioned earlier, is likely to make short term movements unpredictable but, at some stage, this process will work itself out and the value will become more apparent. Returns on cash are negligible and the value of holding it lies for those with extreme risk aversion. We have outlined why we think anything other than the short end of the bond market carries high risks and we would rate this the least attractive of those asset classes. Elsewhere, whilst some high quality commercial property shares may attract because of their large discounts to net asset value, reflecting further expectations of declining net asset values, the sector itself will continue to be affected by the economic climate.

One other lesson to emphasise from last year's stock market performance is the importance of geographical diversification. Sterling investors with international portfolios which were unhedged avoided the worst of the fall in stock markets as foreign currencies rose strongly against sterling. There is a temptation to overweight securities in one's base currency to minimise the effects of exchange rate fluctuations. But, to us, such a policy carries risks and, at a time when the UK's situation deteriorated particularly badly, overseas equity diversification lessened the pain. Even if the majority of sterling's fall has occurred, and this is by no means certain, spreading the risks remains highly advisable.

As a general point, economic and financial life will become more sober and there will be a return to more conventional investment policies. If securities do fall in value as part of normal cycles, there is every chance that they will recover and move ahead. Many of these structures which have flourished during recent years have proved to be flawed, terminally so in many cases, and to have been expensive. An understanding of this situation by investors lays the foundation for a more solid recovery in the stock market in due course.

January 2009